

**Public Version**

**Before the  
Illinois Commerce Commission  
Docket No. 04-0294**

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**AMEREN CORPORATION AND  
ILLINOIS POWER COMPANY**

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Direct Testimony and Exhibit of  
**Michael Gorman**

On behalf of  
**Illinois Industrial Energy Consumers**

Project 8191  
July 2004



Before the  
Illinois Commerce Commission  
Docket No. 04-0294

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ILLINOIS POWER COMPANY

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**Exhibits:**

**MPG-1, Schedule 1**

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ILLINOIS POWER COMPANY**

**Direct Testimony of Michael Gorman**

1    **BACKGROUND**

2    **Q     PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

3    A     My name is Michael Gorman. My business address is 1215 Fern Ridge Parkway, Suite  
4         208, St. Louis, MO 63141-2000.

5    **Q     WHAT IS YOUR OCCUPATION?**

6    A     I am a consultant in the field of public utility regulation and a Principal in the firm of  
7         Brubaker & Associates, Inc., energy, economic and regulatory consultants.

8    **Q     PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE.**

9    A     I have been involved in public utility regulation and utility economic analysis for  
10        approximately 20 years. A more detailed description of my work experience and  
11        education is included in Appendix A to my testimony.

12   **Q     ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?**

13   A     I am appearing on behalf of the Illinois Industrial Energy Consumers (IIEC). The  
14        members of IIEC purchase substantial amounts of electricity from Illinois Power  
15        Company (IP), Ameren Union Electric (UE), Ameren Central Illinois Public Service  
16        Company (CIPS) and Ameren Central Illinois Light Company (CILCO). The IIEC

Companies in the IP service territory will be directly affected by the proposal for the acquisition of IP by Ameren Corporation (Ameren).

**Q WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

A I will respond to Ameren's proposal to acquire all the common and preferred stock of IP from Dynegy. Specifically, I respond to Ameren's and IP's (together referred to as the "Applicants") proposed acquisition and merger subject to the following conditions:

1. Commission approval to eliminate IP's net accumulated deferred income taxes (ADIT) and transfer the tax payment obligation of the income tax to Illinova as partial consideration of IP's affiliate loan to Illinova. The elimination of IP's ADIT will increase IP's rate base and retail rates.
2. Ameren's proposal to amortize \$100 million of acquisition-related expenses as part of IP's cost of service.
3. Ameren's proposal to implement a Hazardous Materials Adjustment Clause (HMAC) rider under IP's electric rate service schedules.

My failure to address any of the conditions of the proposed acquisition and merger should not be considered to be agreement with such a condition.

**Q PLEASE SUMMARIZE YOUR RECOMMENDATIONS IN THIS PROCEEDING.**

A I recommend the proposed acquisition of IP by Ameren be rejected unless modified. Specifically, I find the following components of the transaction not to be in the public interest.

1. The Applicants' own cost projections show that under the proposed reorganization IP's retail delivery service rates, excluding the cost of purchased power and gas, will increase as a result of the transaction. Therefore, the transaction should be rejected because it produces significant adverse rate impacts on IP's retail utility customers.
2. The Applicants' claim that IP can procure gas and purchased power cheaper under Ameren ownership does not offset the increased delivery service rates to IP's customers that will not purchase gas and power from IP. These customers, which conduct their own competitive solicitation for gas and purchased power

acquisitions, will experience adverse delivery service rate impacts under the proposed reorganization.

3. The Applicants' proposal to eliminate IP's ADIT will result in significant adverse rate impacts to IP's retail customers. Eliminating its ADIT will increase IP's net present value (NPV) revenue requirement by more than \$243 million over the period IP's ADIT would have been amortized.
4. The Applicants' proposal to eliminate IP's ADIT will unjustifiably subsidize Illinova's non-utility activities at a significant detriment to IP's retail utility customers in the form of higher utility rates.
5. It is unreasonable to recover \$100 million of acquisition-related fees from IP's retail customers. These costs should not be allocated entirely to IP as a cost of the acquisition. Those costs that are properly allocated to IP should only be recovered to the extent that the Applicants can demonstrate that the acquisition will produce savings which can only be realized as a result of the acquisition, that will offset the amortization of the acquisition-related costs.
6. The Applicants' proposed implementation of a Hazardous Materials Adjustment Clause (HMAC) rider should be rejected. The Applicants have not shown that hazardous materials litigation expenses will significantly impair IP's ability to earn its authorized rate of return on utility investments.
7. The proposed transaction may have severe negative impacts on the number of Alternative Retail Electric Suppliers (ARES) registered to operate in Illinois. If Dynegy loses its ARES status then there would be a severe reduction in the number of competitive suppliers in IP service territory, and all utilities' service territory in Illinois.

#### **ADVERSE UTILITY RATE IMPACT**

**Q SHOULD THE APPLICANTS BE REQUIRED TO DEMONSTRATE THAT THE PROPOSED ACQUISITION WILL NOT ADVERSELY IMPACT IP'S RETAIL RATES?**

**A** Yes. The Applicants acknowledge that Section 7-204 of the Illinois Public Utilities Act (IPUA) (220 ILCS 5/7-204) requires, in part, a demonstration that the proposed reorganization is not likely to result in adverse rate impacts on retail customers (Applicants' Joint Application at 23 and 27).

**Q HAVE THE APPLICANTS ADDRESSED THE ISSUE OF WHETHER THE PROPOSED ACQUISITION WILL HAVE ADVERSE RATE IMPACTS ON IP'S CUSTOMERS?**

A Yes. Ameren witness Mr. Craig Nelson, in Applicants' Exhibit 3.0, claims that there will not be adverse rate impacts under this section prior to 2007. Mr. Nelson contends that the Company will not file to change electric delivery rates prior to 2007. Further, he testified that a rate filing for IP's gas distribution operations is planned, but will be based on the 2003 test year, and will not reflect any costs associated with the acquisition.

Mr. Nelson also offers an analysis that allegedly illustrates post-2007 rate impacts (Applicants' Exhibit 3.4(Revised)). He examines three alternative cases in which he compares IP's revenue requirement under the "Ameren Ownership" scenario compared to IP's revenue requirement under a "Dynergy Ownership" scenario. In each of these cases, Mr. Nelson concludes that the Ameren Ownership scenario has a revenue requirement similar to or lower than IP's revenue requirement under the Dynergy Ownership scenario. Based on this analysis, the Applicants argue that the transaction will not adversely impact retail customers' rates.

**Q DO YOU BELIEVE THAT MR. NELSON'S COMPARISON OF IP'S REVENUE REQUIREMENT UNDER AMEREN OWNERSHIP AND DYNERGY OWNERSHIP SCENARIOS ACCURATELY MEASURES THE POTENTIAL IMPACT ON IP CUSTOMERS' RATES UNDER THE TRANSACTION?**

A No. Mr. Nelson assumes significant savings in gas and purchased power procurement costs under the Ameren Ownership scenario compared to the Dynergy Ownership scenario. As discussed in more detail below, Mr. Nelson's estimate that IP can procure power and gas cheaper under Ameren ownership than it can under the Dynergy Ownership scenario is, at best, speculative. Further, even if true, the Applicants'

representation that retail customers' cost of gas and purchased power will decrease under the proposed transaction and offset increases to utility delivery service costs is not of benefit to customers that do not buy gas and power from IP. Therefore, a proper assessment of the rate impact for retail customers that do not buy gas and power from IP is to review the impact on delivery rates excluding the cost of gas and purchased power procurement.

**Q PLEASE DESCRIBE MR. NELSON'S ASSESSMENT OF THE DELIVERY SERVICE RATE IMPACT ON IP'S RETAIL CUSTOMERS, EXCLUDING GAS AND POWER PROCUREMENT.**

A Based on Mr. Nelson's projections, excluding gas and purchased power expense, IP's costs under Ameren ownership increase compared to the Dynegy Ownership scenario. Therefore, the proposed acquisition will have negative rate impacts on IP's customers that do not buy gas and power from IP. The delivery service revenue requirement from Mr. Nelson's analyses, excluding gas and power procurement, are summarized below in Table 1.

<b>Table 1</b>			
<b>IP Annual Delivery Service Revenue Requirement Under Ameren Versus Dynegy Ownership - Excluding Gas and Purchased Power Costs (\$ Millions)</b>			
<u>Description</u>	<u>Ameren Ownership</u> (1)	<u>Dynegy Ownership</u> (2)	<u>Acquisition Benefit/(Cost)</u> (3)
Case 1	\$639	\$595	(\$44)
Case 2	\$639	\$616	(\$23)
Case 3	\$639	\$636	(\$3)
Applicants' Exhibit 3.4 (Revised)			

1           Mr. Nelson constructed three cases to compare the revenue requirement of IP  
2           under Ameren ownership and Dynegy ownership. For each of the three cases, IP's  
3           revenue requirement under the Ameren ownership case was higher than under the  
4           Dynegy ownership case. However, IP's revenue requirement under Dynegy ownership  
5           varied based on the assumed return on common equity and cost of debt used by  
6           Mr. Nelson in each case. Mr. Nelson assumed a return on common equity and cost of  
7           debt of 10.5% and 7.0%; 11.5% and 8.9%; and 12.5% and 8.8%; for Cases 1, 2 and 3,  
8           respectively.

9           I would note that IP's deteriorated credit standing has been a direct result of its  
10          affiliation with and significant loan to its financially troubled parent company, Dynegy. At  
11          pages 10-11 of his testimony, Mr. Nelson recognizes that Section 9-230 of the PUA  
12          prohibits an increase to a utility's rate of return if the increased cost is attributable to  
13          activities of non-regulated affiliates. Therefore, in my opinion, it would be unlikely that  
14          the Commission would award IP a rate of return significantly higher under the Dynegy  
15          Ownership scenario than it would under an Ameren Ownership scenario. Consequently,  
16          I believe Mr. Nelson's Case 1 is the most appropriate assessment of the difference in  
17          delivery service revenue requirement between Ameren ownership and Dynegy  
18          ownership offered by Mr. Nelson.

19          As clearly indicated in Table 1 above, the Applicants' own projections show that  
20          IP's non-gas and purchased power retail delivery service revenue requirement will be  
21          adversely affected by the transaction.

**Q WHY DO YOU BELIEVE THAT IP'S BELOW INVESTMENT GRADE BOND RATING IS LARGELY ATTRIBUTABLE TO ITS AFFILIATION WITH AND SIGNIFICANT AFFILIATE NOTE TO DYNEGY?**

**A** This is evident from a review of IP credit reports by major credit rating agencies. For example, Fitch Ratings' Global Power/North America Credit Update on Illinois Power Company and Illinova Corp. stated as follows:

"The downgrades for IP and ILN reflect the large intercompany loans with DYN as well as the structural and functional ties between the affiliated companies. IP relies on payments under a \$2.3 billion note receivable from ILN for a large portion of its operating cash flows. Approximately \$170 million of annual interest is received under the note, which is comparable to about 80% of Fitch's estimate of IP's annual 2002 EBITDA, excluding contributions from transmission operations and transition funding bond-related revenues. Through another intercompany note with similar terms, DYN provides the funds to ILN to support its obligations to the utility, thus the payments to IP effectively track back to DYN. In the event that IP would not receive payments on the note, its financial condition would be materially adversely affected. For its part, IP makes payments to DYNH under a power purchase agreement that current expires at the end of 2004." (March 27, 2003 provided in response to IIEC 1-1.)

Moody's Investors Service noted as credit challenges for Illinois Power its cash flow is highly dependent upon cash received from an intercompany note, and uncertainty related to litigation and investigations at Dynegy. Moody's specifically states as follows:

"The Dynegy-IP relationship includes the existence of a power purchase agreement (PPA) between IP and a DHI subsidiary for the purchase of electricity through 2004. Additionally, IP has a note receivable due from Dynegy, which was originally taken as consideration at IP for the transfer of its coal-fired generating assets to a DHI subsidiary. IP makes monthly payments to the DHI subsidiary for the purchase of electricity and Dynegy makes semi-annual payments to IP for amounts due under the note. Annual payments under the note from Dynegy to IP are in excess of the annual payments that IP pays to the DHI subsidiary for purchased power. Dynegy's payments to IP under the intercompany note represent a material amount of IP's annual cash flow." (Moody's Investors Service Opinion Update: Illinois Power Company, December 29, 2003 provided in response to IIEC 1-1.)

1 Finally, Standard & Poor's also identifies Illinois Power's dependence on the  
2 interest income from a \$2.3 billion intercompany note, ultimately from Dynegy, as a  
3 material credit consideration:

4 "The ratings on Illinois Power Co., a wholly owned subsidiary of Illinova  
5 Corp., reflect its consolidated credit strength as well as the credit strength  
6 of its ultimate parent company, Dynegy, Inc. In November 2003, Dynegy  
7 announced the termination of the sale of Illinois Power to Exelon Corp.  
8 Currently, Dynegy is engaged in exclusive discussions with Ameren  
9 Corp. regarding the potential sale of Illinois Power."

10  
11 "Illinois Power's liquidity position is severely constrained. The company  
12 has no access to a dedicated credit facility and relies on payments from  
13 the intercompany loan and support from Dynegy to pay debt service and  
14 meet working capital needs." (Standard & Poor's Ratings Direct: Illinois  
15 Power Co., February 2, 2004 provided in response to IIEC 1-1.)

16 **Q PLEASE DESCRIBE MR. NELSON'S ESTIMATE FOR REDUCED GAS AND**  
17 **PURCHASED POWER PROCUREMENT COSTS FOR IP UNDER THE AMEREN**  
18 **OWNERSHIP SCENARIO.**

19 **A** Mr. Nelson believes that IP's procurement power costs will decline under the Ameren  
20 Ownership scenario due to two factors. First, he believes an improvement to IP's credit  
21 rating will reduce IP's cost for power and gas procurement. Second, he believes that  
22 incorporating IP with the other Ameren operating utilities will result in economies of scale  
23 and greater use of gas storage and access to pipeline capacity will reduce IP's  
24 procurement costs of power and gas supply.

25 Mr. Nelson arrived at his estimated reduction in purchased power costs for IP  
26 under the Ameren Ownership scenario, by reducing the cost of purchased power by a  
27 credit spread of 4.7%, which is based on the difference in long-term debt cost at  
28 AmerenUE and IP. Also, Mr. Nelson included a 1.5% reduction to the cost of gas based  
29 on an economies of scale reduction in IP's procurement costs under the Ameren  
30 Ownership scenario.

1   **Q     WHY DO YOU BELIEVE THE APPLICANTS HAVE FAILED TO PROVE THEIR**  
2       **CONTENTION THAT UNDER AMEREN OWNERSHIP IP'S COST OF GAS AND**  
3       **PURCHASED POWER PROCUREMENT WILL BE LOWER?**

4   **A     I find Mr. Nelson's gas and purchased power cost projections to be problematic for**  
5       several reasons.

6           First, he opines that IP's procurement cost differential is based on the difference  
7       in bond yield spread between Dynegy and Ameren debt. This is not a reasonable  
8       method to estimate the cost impact on commodity procurement caused by IP's below  
9       investment grade credit rating. A bond yield reflects the creditor's risk that is based on  
10      the loan's terms and conditions. A creditor's financial exposure risks are not comparable  
11      to the financial exposure risk a supplier assumes in a commodity supply contract. For  
12      example, a creditor's financial exposure is tied to collecting 100% of the loan amount  
13      when due and receiving annual interest payments. A commodity supplier's financial  
14      exposure is based on the payment terms contained in the supply contract.

15           For a below investment grade customer, a supplier would likely require strict  
16      payment terms of not more than 30 to 60 days receivables or possibly prepayment of  
17      supply before the gas and/or power is delivered. If IP failed to make payment on time, a  
18      contract default would permit a supplier to refuse delivery of additional commodities and  
19      limited its uncollectible losses to 30 to 60 days of supply. In significant contrast, Mr.  
20      Nelson's bond yield spread is based on a full year of uncollectible exposure. Therefore,  
21      at a minimum, Mr. Nelson's yield spread of 4.7% should be adjusted by 1/12 or 1/6 to  
22      reflect a supplier's partial year exposure (one or two months) of supplying IP at its  
23      current bond rating. This would reduce the credit spread cost adjustment to 0.4% to  
24      0.8% from 4.7% of IP's annual gas and purchased power costs. IP's cost would  
25      increase by \$3.5 million to \$8.0 million for its credit risk, not the \$55 million estimated by

1 Mr. Nelson on Exhibit 3.4. Hence, reflecting this conservatively high commodity credit  
2 risk, IP's higher cost of commodities under Dynegy ownership would not offset the  
3 increase in its delivery service rates under Ameren ownership.

4 Second, Mr. Nelson states in his supplemental testimony, that he made this  
5 assumption based on Ameren's expectation that IP would enter into long-term  
6 purchased power and gas procurement agreements, under the Dynegy Ownership  
7 scenario, because that is Ameren's practice for procuring these commodities. However,  
8 Dynegy may not use long-term supply contracts to procure power and gas. Further, Mr.  
9 Nelson's assessment is problematic because it is not known or knowable whether or not  
10 procuring commodities under long-term contracts would result in lower retail prices  
11 compared to procuring the commodities under short-term contracts. The difference  
12 between the procurement costs from using long-term contracts compared to short-term  
13 contracts depends on the relative difference between commodity pricing in a long-term  
14 market and a short-term market. There is no accurate assessment as to whether or not  
15 either will produce lower prices. While Ameren's procurement practices may give more  
16 pricing security and stability to customers, there is simply no reasonable basis for Mr.  
17 Nelson to conclude that they will ultimately produce lower prices.

18 Third, I believe IP's weaker credit rating can be enhanced by credit support such  
19 as letters of credit, supplier prepayment terms, or possibly tariff rates that earmark  
20 ratepayer revenue received by IP to pay only for its gas and power procurement costs.  
21 Therefore, it is quite possible that credit enhancement supporting IP's procurement  
22 practices under a Dynegy Ownership scenario may be considerably lower than that  
23 estimated by Mr. Nelson on Applicants' Exhibit 3.4 and me above.

24 Fourth, I believe IP's credit support requirements may be largely waived if the  
25 commodities are procured from an affiliate supplier. Again, this would indicate that Mr.

1 Nelson's assessment of lower commodity pricing under the Ameren Ownership scenario  
2 is overly optimistic.

3 Finally, and most important, if IP's gas and purchased power procurement costs  
4 are significantly inflated because of IP's weak credit rating, then customers could reduce  
5 their cost of gas and power by procuring the commodities from a competitive supplier  
6 themselves rather than buying the commodities from IP.

7 For all the reasons above, I find Mr. Nelson's estimated savings in gas and  
8 purchased power procurement under Ameren ownership to be highly subjective and  
9 unrealistically inflated.

10 **Q IS MR. NELSON'S CLAIM THAT AMEREN OWNERSHIP WILL REDUCE IP'S COST**  
11 **OF GAS AND POWER BY 1.5% REASONABLE?**

12 **A** No. Mr. Nelson's support for this claim may be good marketing material but it is a  
13 completely unsubstantiated promise and not a legitimate cost reduction estimate. His  
14 primary support seems to be based on his claim that Ameren ownership reduced  
15 AmerenCILCO's cost of gas after it was acquired. But this fails to justify his claim that a  
16 similar cost reduction could be achieved at IP even if it was achieved at CILCO as he  
17 claims. Mr. Nelson did not demonstrate that CILCO's gas system is comparable to IP's,  
18 and thus there is no showing that similar savings might be achievable.

19 More importantly, however, Mr. Nelson applies this assumed cost reduction  
20 percentage to both IP's cost of gas and purchased power. Mr. Nelson has not provided  
21 any evidence that Ameren can reduce IP's cost of purchased power after 2007. Such  
22 evidence would of course be impossible to collect because it is not known what IP's or  
23 Ameren Utilities' cost of purchased power will be after the transition period ends.

**Q WHY DOES IP'S REVENUE REQUIREMENT INCREASE UNDER THE PROPOSED ACQUISITION?**

A There are three reasons IP's revenue requirement will increase. First, the proposed transaction will eliminate IP's ADIT rate base offset. Eliminating ADIT will increase IP's rate base and revenue requirement.

Second, the Applicants' proposal to amortize \$100 million of acquisition-related fees through IP's cost of service will not be offset by a comparable amount of acquisition-related savings.

Third, Ameren is proposing to increase IP's cost of capital by unnecessarily inflating the common equity percentage of total capital.

All of these higher costs are clearly illustrated on Mr. Nelson's analyses shown on Applicants Exhibit 3.4 (Revised).

**Q HOW SIGNIFICANT IS THE ADVERSE RATE IMPACT ON IP'S RETAIL CUSTOMERS IF IP'S ADIT IS ELIMINATED?**

A The dramatic adverse impact on IP's retail net present value (NPV) revenue requirement of eliminating the ADIT is over \$243 million.

**Q HOW DID YOU ESTIMATE THIS ADVERSE RETAIL RATE IMPACT?**

A In response to IIEC Data Request 1.8, the Applicants indicated that IP's ADIT would be amortized through 2051. In Applicants' Exhibit 3.4 (Revised), Mr. Nelson indicates that IP's rate base will increase by approximately \$310 million as a result of the elimination of ADIT.

Eliminating IP's ADIT will increase its rate base and increase IP's required operating income and income tax expense. Therefore, the annual revenue requirement

1 impact is calculated by applying a pre-tax rate of return to the average balance of ADIT  
2 rate base offset for each year the ADIT has a balance. The NPV revenue requirement is  
3 the discounted sum of future revenue requirements.

4 My estimate of the adverse retail rate impact is shown on my Exhibit MPG-1,  
5 Schedule 1. The pre-tax rate of return used in this analysis was based on Mr. Nelson's  
6 capital structure under the Ameren Ownership scenario as reflected in Applicants'  
7 Exhibit 3.4 (Revised). Mr. Nelson assumed that IP's capital structure under the Ameren  
8 Ownership scenario would be composed of 55% equity and 45% debt. He also  
9 assumed a 10.5% return on equity, a 6% embedded cost of debt, and a composite tax  
10 rate of 39.75%. These factors produce a pre-tax weighted average cost of capital of  
11 12.285%.

12 As shown on the attached Schedule, the \$310 million ADIT rate base offset was  
13 amortized over the period ending 2051. The increased revenue requirement due to the  
14 elimination of ADIT is estimated by multiplying the pre-tax rate of return by the  
15 unamortized ADIT rate base offset in each year.

16 The NPV revenue requirement was calculated using IP's after-tax cost of capital  
17 as the discount rate. Using the after-tax cost of capital as the discount rate will establish  
18 a NPV future revenue requirement.

19 **Q PLEASE DESCRIBE THE \$100 MILLION OF ACQUISITION-RELATED FEES THAT**  
20 **THE APPLICANTS ARE PROPOSING TO RECOVER THROUGH IP'S COST OF**  
21 **SERVICE.**

22 **A** These costs are discussed in detail below. There are several reasons why the  
23 Applicants' request to recover \$100 million is not reasonable. First, they have not  
24 properly identified the amount of acquisition costs that are properly allocated to IP's

1 utility delivery service customers. Second, they must clearly demonstrate that the  
2 amount of costs that are properly allocated to IP's utility delivery service customers, are  
3 entirely offset by acquisition-related savings.

4 IP should not be permitted to recover costs that are not properly allocated to IP  
5 utility delivery service customers, unless the acquisition-related transaction costs are  
6 completely offset by bona fide acquisition-related savings at IP's utilities.

7 **Q WHY DO YOU MAINTAIN THAT THE APPLICANTS WILL INCREASE IP'S COST OF**  
8 **CAPITAL BY INFLATING THE COMMON EQUITY PERCENTAGE OF TOTAL**  
9 **CAPITAL?**

10 A As illustrated on the Applicants' Exhibit 3.4 (Revised), under the Dynegy Ownership  
11 scenario, it is assumed that IP will have a percentage of common equity to total capital  
12 of 50%. This amount of common equity is appropriate for maintaining an investment  
13 grade bond rating of IP, excluding the credit degradation caused by its affiliation with and  
14 note to Dynegy. For example, Standard & Poor's publishes financial benchmarks that  
15 identify an appropriate debt to total capital ratio for companies with various business  
16 risks. Standard & Poor's rates companies' business risks on a scale ranging from 1,  
17 lowest business risk, to 10, highest business risk. IP's current business risk position  
18 ranking from Standard & Poor's is 6, but S&P has noted that:

19 "In January 2000, Illinois Power transferred all its remaining generating  
20 capacity to Dynegy Holdings Inc. leaving Illinois Power with a relatively  
21 lower-risk transmission and distribution company that serves more than  
22 565,000 electric customers and 410,000 gas customers" (Standard &  
23 Poor's Ratings Direct, Illinois Power Co., February 2, 2004, Applicants  
24 response to IIEC 1-1, emphasis added).

25 This S&P statement implies that IP's business risk rating may improve if it sheds its  
26 Dynegy affiliate risks. However, even if IP's business position rating doesn't improve, a

1 50% common equity ratio is adequate to maintain an investment grade bond rating.  
2 With a business position ranking of 6, Standard & Poor's states that a total debt to total  
3 capitalization ratio in the range of 46% to 53.5%, can support a "BBB" investment grade  
4 utility bond rating.<sup>1</sup> I would note that in its report on IP dated March 1, 2004, S&P did not  
5 reflect any off-balance sheet debt obligations for IP under Dynegy ownership in  
6 computing IP's total debt ratio. (Provided in response to IIEC 1-1). This implies that a  
7 percentage of common and preferred equity in a range of 54% to 46.5% is supportive of  
8 an investment grade bond rating.

9 Consequently, the 50% common equity ratio under continued Dynegy ownership  
10 supports an investment grade bond rating at IP under Dynegy ownership. Moreover, If  
11 IP's business position rating improves to reflect only its transmission and distribution  
12 risk, a common equity ratio of 50% would be supportive of an "A" S&P bond rating with a  
13 business position rating of 3.<sup>2</sup>

14 Under the Ameren Ownership scenario, the Applicants are proposing a dramatic  
15 increase to IP's common equity ratio up to the range of 50% to 60%. Mr. Nelson is  
16 assuming a 55% common equity ratio in his revenue requirement analysis. By  
17 increasing IP's percentage of common equity to total capital, the Applicants are  
18 proposing to significantly increase IP's rate setting cost of capital. Common equity is the  
19 highest cost form of capital, and is subject to income tax expense. Indeed, on a pre-tax  
20 cost of capital basis, common equity is nearly three times as expensive as debt capital.  
21 For example, using Mr. Nelson's projections, IP's pre-tax cost of common equity would  
22 be 17.4% ( $10.5\% / (1 - \text{composite tax rate of } 39.75\%)$ ), compared to a pre-tax cost of debt

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<sup>1</sup> S&P Utilities Perspectives, Utility Financial Targets Revised June 21, 1999.

<sup>2</sup> S&P's total debt ratio range for an "A" rating at a business position rating of "3" is 47.5% to 53.0%.

1 of 6%. Therefore, increasing IP's common equity ratio will increase its rate setting cost  
2 of capital.

3 In sum, the Applicants' proposal to inflate IP's common equity percentage of total  
4 capital is not necessary in order to support an investment grade bond rating at IP, and  
5 will substantially increase IP's revenue requirement and utility rates.

6 **UNJUSTIFIED NON-UTILITY SUBSIDIZATION**

7 **Q WILL ELIMINATION OF THE ADIT BALANCE RESULT IN THE SUBSIDIZATION OF**  
8 **NON-UTILITY ACTIVITIES BY IP?**

9 A Yes. IP's ADIT balances are actual cash contributions made by IP's retail utility  
10 customers to pay IP's future income tax liabilities. Because IP has not yet paid these  
11 ADIT tax expenses to the IRS, they are reflected as a zero cost source of capital to  
12 support IP's utility plant and services. IP's customers receive the benefits of this zero  
13 cost capital source in the ratemaking calculus.

14 The Applicants propose to transfer the future ADIT payment obligation which is  
15 carried at a zero percent capital cost, to Illinova in exchange for a reduction of Illinova's  
16 affiliate loan obligation to IP that has an annual interest rate of 7.5%. IP's retail  
17 ratepayers do not receive any benefit or direct cost of this affiliate loan. This exchange  
18 benefits Illinova/Dynegy by reducing Illinova's affiliate loan obligation and annual interest  
19 cost. The exchange is to the detriment of IP's retail utility customers because the  
20 exchange increases IP's utilities' cost of service and increases retail rates.

21 Clearly, IP's non-utility affiliates benefit at the expense of regulated utility  
22 operations by the proposal to reduce Illinova's affiliate note obligation to IP by the  
23 transfer of ADIT payment obligations and the elimination of IP's ADIT.

**RECOVERY OF \$100 MILLION TRANSACTION COSTS**

**Q PLEASE DESCRIBE THE TRANSACTION COSTS OF ACQUISITION THE APPLICANTS ARE PROPOSING TO RECOVER IN IP'S RETAIL ELECTRIC RATES.**

A The Applicants propose to amortize \$100 million of acquisition-related costs in IP's retail electric rates. They are proposing a six-year amortization of these costs starting in calendar year 2005. Since they are not requesting to reflect these costs specifically in retail rates until the beginning of 2007, the Applicants maintain that their request will amortize \$67 million of these acquisition costs over a four-year period starting in calendar year 2007.

Although the Applicants do not specifically identify which costs are included in the \$100 proposed acquisition cost regulatory asset, they do identify over \$450 million of acquisition-related costs at Pages 7 and 8 of Applicant witness Martin J. Lyons' testimony. These costs are summarized below in Table 2.

<b>Table 2</b>	
<b><u>Summary of Applicants' Acquisition Costs</u></b>	
<u>Description</u>	<u>Amount</u> (Millions)
Premium to Book Value	\$275
Stock Issuance Costs	35
Transaction Costs	25
Integration Costs	10
Severance Costs	9
Debt Redemption Premium	<u>100</u>
Total	\$454
<hr/> Applicants' Exhibit 5.0 at 7-8	

1 It is important to identify the specific costs the Applicants propose to recover through IP's  
2 delivery service rates. It is important because many of these costs are either not  
3 appropriate for recovery through retail rates, or should be properly allocated between all  
4 of Ameren's affiliates, or IP's business segments including its retail utility services, the  
5 Applicants' purchase of Illinova's 20% interest in Electric Energy Inc. (EEI) and IP's  
6 significant investment in the affiliate note with Dynegy. Without an accurate description  
7 of which costs the Applicants are proposing to recover through IP's retail utility rates, the  
8 Commission cannot ensure that utility rate recovery is reasonable and should therefore  
9 reject recovery of these costs through utility rates.

10 **Q ARE ALL OF THESE COSTS APPROPRIATELY RECOVERED AS AN ACQUISITION**  
11 **PREMIUM IN IP'S RATES?**

12 **A** No. Each of these cost items will be discussed individually.

- 13 • The premium to book value of \$275 million represents the difference between the  
14 Applicants' estimated acquisition price for IP's utility assets and Illinova's 20%  
15 interest in EEI, and the net book value of these assets. I note that the Applicants  
16 appear to attribute the entire premium to the book value of IP's retail utility  
17 assets. This is despite the fact that they are not only buying IP's retail  
18 operations, but they are also acquiring Illinova's 20% ownership of EEI and  
19 eliminating an affiliate note agreement between IP and Dynegy which is a key  
20 provision of the reorganization. The proposed acquisition of IP's assets is a very  
21 complicated transaction that deals with much more than just IP's retail utility  
22 functions. This acquisition premium should, at a minimum, be allocated among  
23 all the major activities undertaken in the transaction.
- 24 • The issuance cost of \$35 million relates to Ameren Corporation's issuance of  
25 common equity to fund the acquisition. Ameren's stock issuance expenses are  
26 not IP's specific expenses. Ameren's stock issuance expense should be  
27 allocated among all the Ameren operating affiliates, both regulated and non-  
28 regulated. To the extent they provide accurate accounting of these stock  
29 flotation expenses, Ameren can seek recovery of the expense in the next base  
30 rate filings for each affiliate company based on properly allocated amounts.  
31 These stock issuance expenses should not be subject to recovery as an  
32 acquisition cost in this transaction.

- The proposal to recover the \$44 million of transaction costs, integration costs, and employee severance costs should be allocated between the IP utility businesses and the Joppa generation plant.
- The debt redemption premium of \$100 million should not be allocated to IP's utility operations. These debt restructuring costs should be allocated to restructuring the Illinova affiliate note and reduction of the debt that previously supported IP's generating assets. This debt restructuring is not related to utility operations.

**Q UNDER WHAT CONDITIONS SHOULD THE COMMISSION PERMIT THE APPLICANTS TO RECOVER IN IP'S RETAIL RATES AN ALLOCATED PORTION OF THE \$44 MILLION OF TRANSACTION, INTEGRATION AND SEVERENCE COSTS?**

**A** IP should only be allowed to recover an allocated portion of the \$44 million transaction, integration and severance costs to the extent that the Applicants can show that acquisition savings will materialize that more than cover the recovery of these expenses from retail utility customers.

Under no circumstances should the Applicants be allowed to increase retail electric rates to pay the costs associated with this acquisition. Consequently, the Applicants' demonstration of acquisition savings must clearly show that the savings can only have been achieved under the acquisition. If the estimated cost reductions could have been achieved by IP absent the acquisition, then they should not be considered acquisition-related savings.

**HAZARDOUS MATERIALS ADJUSTMENT CLAUSE (HMAC) RIDER**

**Q PLEASE DESCRIBE THE APPLICANTS' PROPOSED HMAC RIDER.**

**A** The Applicants' are proposing to implement an HMAC rider effective on January 2, 2007, which will permit IP to recover prudent costs, net of insurance recoveries and other

contributions, associated with certain claims related to asbestos exposure (Application at 37).

**Q IS THE APPLICANTS' PROPOSAL FOR AN HMAC RIDER REASONABLE?**

A No. IP's proposed HMAC rider should be rejected for the following reasons:

1. In response to Data Request DLH 1.08

Highly confidential material was redacted for Public Version of this testimony.

These expenses are not significant and do not represent a significant risk that inhibits IP's ability to earn its authorized rate of return.

2. IP recorded a contingency reserve

Highly confidential material was redacted for Public Version of this testimony.

(Response DLH 4.07). Clearly, IP is able to reasonably estimate the litigation expense and can include a representative amount in the development of base rates. A special rider is not necessary to provide recovery of these expenses.

3. From a policy perspective, the Commission should not implement the HMAC rider because it will reduce IP's incentive to aggressively protect itself and mitigate its expense associated with asbestos litigations. If the HMAC rider is implemented, IP will have less economic incentive to aggressively protect itself and retail customers from asbestos litigation costs.

For all of these reasons, the Company's HMAC rider should be rejected.

**Q DID IP WARN ITS INVESTORS THAT ASBESTOS-RELATED EXPENSES CAN SIGNIFICANTLY IMPACT ITS RESULTS OF OPERATIONS?**

A No, to the contrary. IP informed investors that asbestos-related exposure is not significant. In IP's 2003 Securities and Exchange Commission 10K, IP stated as follows:

"As of December 31, 2003, forty-five lawsuits were pending against us for illnesses based on alleged exposure to asbestos at generation facilities

Highly confidential material was redacted for Public Version of this testimony.

1 previously owned by us. Thirty-five asbestos lawsuits were served on us  
2 during 2003, with seven of these served subsequent to September 30,  
3 2003. We were dismissed, without prejudice, from two lawsuits during  
4 2003. We intend to vigorously defend against the remaining pending  
5 lawsuits. We have recorded a reserve with respect to the pending  
6 lawsuits, however, we do not expect the outcome of any such pending  
7 lawsuits to have a material adverse effect upon our results of operations.”  
8 (Provided in response to DLH 4.07).

9 **COMPETITION**

10 **Q ARE THERE ANY OTHER CONCERNS YOU HAVE ABOUT THE PROPOSAL FOR**  
11 **AMEREN TO ACQUIRE IP?**

12 A Yes. Based on advice of counsel, I understand it is possible that Dynegy's sale of IP  
13 may cause Dynegy to lose its status as an Alternative Retail Electric Supplier (ARES) in  
14 Illinois. Currently, Dynegy operates two ARES in Illinois, Dynegy Energy Services  
15 outside of IP's service territory, and Illinois Power Energy inside IP's service territory.  
16 Consequently, it may be possible that two ARES may disappear from the Illinois  
17 competitive solicitation market. This is a significant loss in that no utility service territory  
18 had more than eight active ARES during the period 2000-2003 (Illinois Commerce  
19 Commission report dated April 2004 "*Competition in Illinois Retail Electric Markets in*  
20 *2003*" at 7). Importantly, this document only identifies three active ARES in IP's service  
21 territory in 2003. The loss of Dynegy as an ARES in IP's service territory would reduce  
22 that number by 33%. Therefore, the proposed transaction may have severe detrimental  
23 impacts on competition in Illinois.

24 **Q DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

25 A Yes, it does.

**Qualifications of Michael Gorman**

1    **Q     PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2    A     Michael P. Gorman. My business mailing address is P. O. Box 412000, 1215 Fern  
3           Ridge Parkway, Suite 208, St. Louis, Missouri 63141-2000.

4    **Q     PLEASE STATE YOUR OCCUPATION.**

5    A     I am a consultant in the field of public utility regulation and a principal at Brubaker &  
6           Associates, Inc., energy, economic and regulatory consultants.

7    **Q     PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND WORK  
8           EXPERIENCE.**

9    A     In 1983 I received a Bachelors of Science Degree in Electrical Engineering from  
10          Southern Illinois University, and in 1986, I received a Masters Degree in Business  
11          Administration with a concentration in Finance from the University of Illinois at  
12          Springfield. I have also completed several graduate level economics courses.

13                In August of 1983, I accepted an analyst position with the Illinois Commerce  
14                Commission (ICC). In this position, I performed a variety of analyses for both formal and  
15                informal investigations before the ICC, including: marginal cost of energy, central  
16                dispatch, avoided cost of energy, annual system production costs, and working capital.  
17                In October of 1986, I was promoted to the position of Senior Analyst. In this position, I  
18                assumed the additional responsibilities of technical leader on projects, and my areas of  
19                responsibility were expanded to include utility financial modeling and financial analyses.

20                In 1987, I was promoted to Director of the Financial Analysis Department. In this  
21                position, I was responsible for all financial analyses conducted by the staff. Among other  
22                things, I conducted analyses and sponsored testimony before the ICC on rate of return,

1 financial integrity, financial modeling and related issues. I also supervised the  
2 development of all Staff analyses and testimony on these same issues. In addition, I  
3 supervised the Staff's review and recommendations to the Commission concerning utility  
4 plans to issue debt and equity securities.

5 In August of 1989, I accepted a position with Merrill-Lynch as a financial  
6 consultant. After receiving all required securities licenses, I worked with individual  
7 investors and small businesses in evaluating and selecting investments suitable to their  
8 requirements.

9 In September of 1990, I accepted a position with Drazen-Brubaker & Associates,  
10 Inc. In April 1995 the firm of Brubaker & Associates, Inc. (BAI) was formed. It includes  
11 most of the former DBA principals and Staff. Since 1990, I have performed various  
12 analyses and sponsored testimony on cost of capital, cost/benefits of utility mergers and  
13 acquisitions, utility reorganizations, level of operating expenses and rate base, cost of  
14 service studies, and analyses relating industrial jobs and economic development. I also  
15 participated in a study used to revise the financial policy for the municipal utility in  
16 Kansas City, Kansas.

17 At BAI, I also have extensive experience working with large energy users to  
18 distribute and critically evaluate responses to requests for proposals (RFPs) for electric,  
19 steam, and gas energy supply from competitive energy suppliers. These analyses  
20 include the evaluation of gas supply and delivery charges, cogeneration and/or  
21 combined cycle unit feasibility studies, and the evaluation of third-party asset/supply  
22 management agreements. I have also analyzed commodity pricing indices and forward  
23 pricing methods for third party supply agreements. Continuing, I have also conducted  
24 regional electric market price forecasts.

25 In addition to our main office in St. Louis, the firm also has branch offices in  
26 Corpus Christi, Texas; Plano, Texas; Denver, Colorado; and Chicago, Illinois.

1    **Q     HAVE YOU EVER TESTIFIED BEFORE A REGULATORY BODY?**

2    A     Yes. I have sponsored testimony on cost of capital, revenue requirements, cost of  
3           service and other issues before the Federal Energy Regulatory Commission and state  
4           regulatory commissions in Arizona, Colorado, Delaware, Florida, Georgia, Illinois,  
5           Indiana, Iowa, Michigan, Missouri, New Mexico, New York, Oklahoma, South Carolina,  
6           Tennessee, Texas, Utah, Vermont, West Virginia, Wisconsin and Wyoming. I have also  
7           sponsored testimony before the Commission of Public Utilities in Kansas City, Kansas;  
8           presented rate setting position reports to the regulatory Commission of the municipal  
9           utility in Austin, Texas, and Salt River Project, Arizona, on behalf of industrial customers;  
10          and negotiated rate disputes for industrial customers of the Municipal Electric Authority  
11          of Georgia in the LaGrange, Georgia district.

12   **Q     PLEASE DESCRIBE ANY PROFESSIONAL REGISTRATIONS OR ORGANIZATIONS**  
13   **TO WHICH YOU BELONG.**

14   A     I earned the designation of Chartered Financial Analyst (CFA) from the Association for  
15           Investment Management and Research (AIMR). The CFA charter was awarded after  
16           successfully completing three examinations which covered the subject areas of financial  
17           accounting, economics, fixed income and equity valuation and professional and ethical  
18           conduct. I am a member of AIMR's Financial Analyst Society.  
19

MPG:cs/8191/47671

**AMEREN CORPORATION AND ILLINOIS POWER COMPANY**

**ADIT Revenue Requirement Impact**  
**(Millions)**

<u>Year</u>	<u>Rate Base Impact ADIT Elimination</u> (1)	<u>Pre-Tax Rate of Return</u> (2)	<u>Revenue Requirement</u> (3)
2007	\$310	12.29%	\$38
2008	\$291	12.29%	\$36
2009	\$271	12.29%	\$33
2010	\$252	12.29%	\$31
2011	\$233	12.29%	\$29
2012	\$214	12.29%	\$26
2013	\$195	12.29%	\$24
2014	\$175	12.29%	\$22
2015	\$156	12.29%	\$19
2016	\$137	12.29%	\$17
2017	\$118	12.29%	\$14
2018	\$99	12.29%	\$12
2019	\$84	12.29%	\$10
2020	\$76	12.29%	\$9
2021	\$73	12.29%	\$9
2022	\$70	12.29%	\$9
2023	\$66	12.29%	\$8
2024	\$63	12.29%	\$8
2025	\$60	12.29%	\$7
2026	\$57	12.29%	\$7
2027	\$53	12.29%	\$7
2028	\$50	12.29%	\$6
2029	\$47	12.29%	\$6
2030	\$45	12.29%	\$5
2031	\$42	12.29%	\$5
2032	\$40	12.29%	\$5
2033	\$38	12.29%	\$5
2034	\$36	12.29%	\$4
2035	\$33	12.29%	\$4
2036	\$31	12.29%	\$4
2037	\$29	12.29%	\$4
2038	\$27	12.29%	\$3
2039	\$25	12.29%	\$3
2040	\$22	12.29%	\$3
2041	\$20	12.29%	\$2
2042	\$18	12.29%	\$2
2043	\$16	12.29%	\$2
2044	\$14	12.29%	\$2
2045	\$12	12.29%	\$1
2046	\$10	12.29%	\$1
2047	\$7	12.29%	\$1
2048	\$5	12.29%	\$1
2049	\$3	12.29%	\$0
2050	\$2	12.29%	\$0
2051	\$1	12.29%	\$0

NPV Revenue Requirement

\$243

**AMEREN CORPORATION AND ILLINOIS POWER COMPANY**

**ADIT Revenue Requirement Impact**

**Applicant's Estimate of IP's Cost of Capital Under Ameren Ownership**

<u>Line</u>	<u>Description</u>	<u>Weight</u> (1)	<u>Cost</u> (2)	<u>Weighted</u> <u>Cost</u> (3)	<u>Pre-Tax</u> <u>Weighted</u> <u>Cost</u> (4)	<u>After-Tax</u> <u>Weighted</u> <u>Cost</u> (5)
1	Common Equity	55%	10.50	5.78	9.59	5.78
2	Debt	45%	6.00	2.70	2.70	1.63
3	Total Capital	100%		8.48	12.29	7.40